

Warranties Notes

Overview of Warranties

Warranties are commitments made by a seller to repair or replace a product if it fails to perform as expected within a specified period. They are common in product sales and are accounted for as liabilities under **ASC 460** (US GAAP) and **IAS 37** (IFRS). Warranties are classified into two types: **assurance-type warranties** and **service-type warranties**, each with distinct accounting treatments.

Purpose of Warranty Accounting

- To recognize the estimated cost of fulfilling warranty obligations as a liability at the time of sale.
- To match warranty expenses with the revenue generated from the sale, adhering to the matching principle.
- To provide transparent financial reporting for potential obligations.

Types of Warranties

Warranties are classified based on their nature and the obligations they impose on the seller:

1. Assurance-Type Warranties

- These warranties assure that the product meets agreed-upon specifications or is free from defects at the time of sale.
- Typically included in the product's sales price and not separately priced.
- **Accounting:** Recognized as a liability at the time of sale based on the estimated cost of fulfilling warranty claims.
- Losses are accrued if it is probable that a liability has been incurred and the amount can be reasonably estimated.

2. Service-Type Warranties

- These warranties provide additional services beyond assuring product quality, such as extended coverage or maintenance services.
- Often sold separately for an additional fee or as an optional add-on.
- **Accounting:** Recognized as a separate performance obligation under ASC 606 (Revenue from Contracts with Customers) or IFRS 15. The portion of the transaction price allocated to the service-type warranty is deferred as a liability and recognized as revenue over the warranty period.

Classifying Warranties

To determine whether a warranty is assurance-type or service-type, companies consider:

- Whether the warranty is required by law (typically assurance-type).
- The length of the warranty coverage (longer periods may indicate service-type).
- The nature of the tasks promised (e.g., repairs vs. additional services like upgrades).

- Whether the warranty is separately priced or optional (service-type).

Accounting for Warranties

Assurance-Type Warranties

- **Recording the Warranty Liability:** At the time of sale, estimate the expected cost of warranty claims and record a liability.

- **Journal Entry at Sale:**

- Dr Warranty Expense XXX

Cr Assurance-Type Warranty Liability XXX

- **Warranty Claim Fulfillment:** When a warranty claim is incurred, reduce the liability and recognize the cost.

- **Journal Entry for Claim:**

- Dr Assurance-Type Warranty Liability XXX

Cr Cash (or Inventory, Parts) XXX

- **Periodic Evaluation:** At each reporting date, reassess the warranty liability based on updated estimates of remaining claims. Adjust the liability with a corresponding debit or credit to Warranty Expense.

- Dr/Cr Warranty Expense XXX

Cr/Dr Assurance-Type Warranty Liability XXX

Service-Type Warranties

- **Recording the Warranty Liability:** Allocate a portion of the transaction price to the service-type warranty and defer it as a liability.

- **Journal Entry at Sale:**

- Dr Cash XXX

- Cr Sales Revenue XXX

Cr Service-Type Warranty Liability XXX

- **Revenue Recognition:** Recognize the deferred revenue over the warranty period (e.g., using the straight-line method unless another pattern better reflects the service delivery).

- **Journal Entry for Revenue Recognition:**

- Dr Service-Type Warranty Liability XXX

Cr Warranty Revenue XXX

- **Warranty Expenses:** Costs incurred to fulfill service-type warranty obligations (e.g., repairs, replacements) are expensed as incurred.

- **Journal Entry for Expenses:**

Cr Cash (or Salaries, Parts Inventory) XXX

Example: Warranty Accounting

A manufacturer sells a product for \$5,000 per unit, offering a one-year assurance-type warranty included in the price and an optional four-year service-type warranty for \$200. The estimated cost of assurance-type warranty claims is \$100 per unit for the first year. The service-type warranty covers years 2 through 5.

- Journal Entry at Sale (per unit):

- Dr Cash 5,200
- Cr Sales Revenue 5,000
- Cr Service-Type Warranty Liability 200
- Dr Assurance-Type Warranty Expense 100

Cr Assurance-Type Warranty Liability	100
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- **During Year 1 (Assurance-Type Warranty Claim):** If a \$50 repair is made:

- Dr Assurance-Type Warranty Liability 50

Cr Cash (or Parts Inventory)	50
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- **During Years 2–5 (Service-Type Warranty):** If \$60 in repair costs are incurred in Year 2:

- Dr Service-Type Warranty Expense 60

Cr Cash (or Parts Inventory)	60
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- Revenue Recognition for Service-Type Warranty:** Assuming straight-line recognition over 4 years ($\$200 \div 4 = \50 per year):

- Dr Service-Type Warranty Liability 50

Cr Warranty Revenue	50
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Off-Balance Sheet Financing

The original notes included a brief section on **Off-Balance Sheet Financing**, which is unrelated to warranties but relevant to financial reporting. It is included here for completeness.

Definition

Off-balance sheet financing refers to funding arrangements that do not appear as liabilities, assets, or equity on the balance sheet, potentially obscuring a company's financial position.

Methods of Off-Balance Sheet Financing

- **Operating Leases:** Historically, operating leases allowed companies to use assets without recognizing them on the balance sheet. Under ASC 842 (US GAAP) and IFRS 16, most leases are now recognized as right-of-use assets and lease liabilities.

- **Special Purpose Entities (SPEs):** Used to isolate financial risk or securitize assets, keeping related liabilities off the balance sheet (subject to consolidation rules under ASC 810 or IFRS 10).
- **Joint Ventures or Partnerships:** Sharing ownership of assets to avoid full recognition on the balance sheet.

Impact

- Off-balance sheet financing can enhance financial ratios but may hide risks.
- Enhanced disclosure requirements under modern standards aim to improve transparency.

Example Problem: Warranties in a Business Combination

Scenario: On January 1, 2025, Company A acquires Company B for \$2,000,000 in a business combination. The fair value of Company B's net identifiable assets is \$1,600,000, including an assurance-type warranty liability of \$50,000 for products sold prior to acquisition. Post-acquisition, Company A estimates that an additional \$20,000 in warranty claims will be incurred for products sold by Company B before the acquisition. Record the acquisition and the adjustment to the warranty liability.

Solution:

1. **Calculate Goodwill:**

- Purchase Price: \$2,000,000
- Fair Value of Net Identifiable Assets: \$1,600,000
- Goodwill = \$2,000,000 - \$1,600,000 = \$400,000

2. Journal Entry for Acquisition:

- | | | |
|----|--------------------------------------|-----------|
| 3. | Dr Net Identifiable Assets | 1,650,000 |
| 4. | Dr Goodwill | 400,000 |
| 5. | Dr Assurance-Type Warranty Liability | 50,000 |

Cr Cash	2,000,000
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6. Adjust Warranty Liability Post-Acquisition:

- Additional estimated claims: \$20,000
- Journal Entry:
- Dr Warranty Expense 20,000

Cr Assurance-Type Warranty Liability	20,000
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Additional Notes

- **IFRS vs. US GAAP:**
 - Under IFRS (IAS 37), warranty obligations are treated as provisions and recognized when probable and estimable.

- US GAAP (ASC 460) distinguishes between assurance-type and service-type warranties, with service-type warranties treated as separate performance obligations under ASC 606.
- **Tax Implications:** Warranty expenses are generally deductible when incurred, but tax rules may differ from financial reporting, creating temporary differences.
- **Disclosures:** Companies must disclose the nature, estimated amount, and timing of warranty liabilities, as well as any significant changes in estimates.